



FINANCIAL LITERACY FOR YOUTHS



6 Basic Financial Ratios before Making an Investment



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Before making any investments, there is a need to do some homework to source out the viability of the investment. It is highly irrational to invest in a company just because we ‘feel’ that the stock price will rise in the near future. In-depth research should be done to determine the risks involved and only calculated risks should be taken. Otherwise, you are not better off in terms of succeeding from your investment as if it lies on a game of russian roulette. These traits differentiate between a competent investor and a speculator. Of course, there are thousands of methods out there in the internet on how to start and it may seem tedious and confusing upon first glance, but in fact is not if you start young and learn from credible sources. As a start, let us look at the 6 basic financial ratios that can be used to analyse the financial position of a company and how can they help to make your investment a success.

Return on Equity (ROE)

ROE should first to be analysed before you invest into the shares of a company. It is arguably the most important ratio in the world of business finance (Walsh, 2003a). Equity, in layman’s term means money invested by shareholders into the company, where in return they gain dividends if the company makes profits and decides to distribute dividends, or capital gains when the share price increases (assume that they bought in at a lower price). ROE shows how profitable its capital return to shareholders in the business. In other words, it measures how profitable the company is with accordance to every dollar invested, where a higher ROE value shows a better ability of the company to generate profits.

$$\text{Return on Equity} = \frac{\text{Net Profit} - \text{Preference Dividends}}{\text{Ordinary Equity}}$$

Usually, a company which has ROE of more than 15% is considered profitable. A high and growing ROE results in a high share price and makes it easy to attract new funds as these investors will want a share of the profits and experience capital gains on their investments in the future.

Current Ratio

Current ratio shows the ability of an entity to pay its short-term liabilities with the current assets that they have, hence calculated by dividing current assets by current liabilities. Current assets are items that the company own that could be liquidated into cash within a short period. Some examples include cash and cash equivalents, receivables from customers, short-term investments, prepaid expenses and inventories, Current liabilities are short term obligations that the company has, such as money owed to suppliers. A low current ratio may indicate inability for a company to meet its short-term debts in the event of an emergency. A rule of thumb, the current ratio should be at least 1.5:1 to be considered safe to invest in and 2:1 to be considered as the “perfect” mix between the current assets and current liabilities of the company (YCharts, 2017).

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

However, there is a disadvantage of this ratio. Current ratio does not differentiate between different types of current assets, some of which are far more liquid than other (Walsh, 2003b). Some unit trust investments, term deposits, securities and bond investments are also categorised as current assets as they mature within 12 months, but are not as liquid as cash. This issue is addressed in the next ratio.

Quick Ratio

Quick ratio shows us a more accurate measure of liquidity as compared to current ratio. It provides us with information on how well the short-term debts can be covered by cash and by items that can be easily liquidated to cash. Quick ratio is calculated by adding cash or cash equivalents with receivables and assets that can be easily liquidated into cash, then divided by current liabilities (Hoggett et al., 2015a). It also can be calculated by deducting inventories off current assets and only then divided by current liabilities as inventories may not be able to be liquidated into cash during periods of weak demand.

$$\text{Quick Ratio} = \frac{\text{Cash Assets} + \text{Liquidable Assets} + \text{Receivables}}{\text{Current Liabilities}}$$

OR

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

Current ratio is a favourite of the banks as it can be used to gauge the ability of a company to repay its short-term liabilities subsequently reducing the risk of the lender defaulting on their loans. From the perspective of the shareholder of a company, you too would want your company able to repay your short-term debt, wouldn't you?

Earnings per Share (EPS)

Data on earnings per share (EPS) can be commonly found in a company's financial statements and securities exchange reports on the internet. This ratio shows the net income earned on each share issued by the company. For example, ABC Berhad has an EPS of 11 cents, which means the company earned 11 cents for each share issued. A company with higher EPS compared to its competitors in a same industry is more favourable as it demonstrates the ability to generate profits from its available resources (Walsh, 2003c).

$$\text{Earnings per Share} = \frac{\text{Profit after Tax} - \text{Preference Dividends}}{\text{Outstanding Shares}}$$

Price Earnings Ratio (P/E Ratio)

Price Earnings ratio is calculated by dividing the share price of the company's stock by its EPS, (Hoggett et al., 2015b). This ratio measures how much an investor would have to pay for each dollar of earnings. Assuming that ABC Berhad has an average market share price of RM1.71 per share and EPS of 11 cents, the P/E ratio is 15.5 times,

$$\text{P/E Ratio} = \frac{\text{Market Price per Ordinary Share}}{\text{Earnings per Ordinary Share (EPS)}}$$

$$\text{P/E Ratio} = \frac{\text{RM 1.71}}{\text{RM 0.11}} = 15.5$$

It is important to compare P/E ratio of companies only in the same industry, as P/E ratio of different sectors tend to be different. There is no point comparing P/E ratios from companies in the banking industry and those in the IT industry as the share prices and earnings will be different for these 2 industries.

High P/E ratios tends to signify high growth. However, when the P/E ratio gets too high, it might indicate that either the company is expanding too rapidly, or the share price of the company is overpriced. Paradoxically, low P/E ratios signifies low growth or underpriced share prices.

Debt/Equity Ratio

Debt/Equity ratio measures a company's financial leverage by comparing its total debt to total equity. Also known as the Debt-to-Equity ratio, it is calculated by adding long and short-term debt, and dividing it by the shareholders' equity to measure the obligations present in the to fund their assets in respect of the amount of shareholders' equity available (Walsh, 2003d).

$$\text{Debt/Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$$

When a company has a high debt-to-equity ratio compared to the industry average, it simply means that the company is borrowing too much debt to finance their assets. To some drastic extent, it may also indicate that the company is having some financial problems. Besides, a company with high debt-to-equity ratio is very unlikely to be profitable because the company is relying too much on debts to grow its business and incurs high interest costs towards their creditors.

Conclusion

As a conclusion, these 6 basic financial ratios should be analysed before you invest your hard-earned money into stock market. It is also essential to compare these ratios among companies in the same industry only, as companies in certain industry leverage on debts to earn more profit. For instance, banking and finance industry tends to has higher debt-to-equity ratio as compared to consumer goods industry. As mentioned before, there are various ways to analyse and evaluate a company's



financial position. So as a start, investors should always keep these 6 ratios in mind as they are the fundamentals of fundamentals before making an investment. Remember, no investment will be risk-free (even treasure/government bonds, risk is almost 0 but definitely not 0) and it is the job of the investor to try to mitigate these risks in order to maximise their returns from the investments they chose.

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